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No. 24[illegible]

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

C. D. SPANGLER AND VEVA C. SPANGLER, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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The petitioners, by their undersigned Counsel, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit in the above entitled case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States (Appendix B) are officially reported at 32 T.C. 782. The decision of the Tax Court was affirmed by the United States Court of Appeals for the Fourth Circuit on April 18, 1960 (Docket No. 8005), and its opinion (Appendix D) is officially reported at F. 2d

JURISDICTION

The judgment of the Court of Appeals was entered on April 18, 1960. (Appendix D). The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Does the retroactive application of Section 117(m), Internal Revenue Code of 1939, enacted September 23, 1950, to an irrevocable distribution made on May 24, 1950, to petitioner by a corporation which he controlled, and the taxing of such distribution to petitioner as ordinary income, constitute a taking of property without due process of law in contravention of Amendment V of the Constitution of the United States?

2. Were the initial regulations issued by the Secretary of the Treasury on March 26, 1953, relating to Section 117(m), Internal Revenue Code of 1939, a contemporaneous construction of such section, and do such regulations, which interpret Section 117(m) to be applicable to distributions by a corporation under Section 115(d), Internal Revenue Code of 1939, relating to other distributions out of capital, constitute an invalid extension of the statute to cover transactions not contemplated by Congress?

3. Where a corporation has not realized any *net* income from constructed property for a period of seven (7) years immediately following the completion of construction, and there is no proof that it will ever realize any *net* income from such property, does the application of Section 117(m), Internal Revenue Code, to a distribution by such corporation constitute an arbitrary and invalid application and interpretation of such statute in contravention of Amendment V of the Constitution of the United States?

CONSTITUTIONAL PROVISION, STATUTES AND REGULATIONS INVOLVED

CONSTITUTION OF THE UNITED STATES:

Fifth Article of Amendment:

"No person shall * * * be deprived of life liberty, or property, without due process of law; * * *."

STATUTES:

The statutory provisions involved are Sections 22(a) and (e), 115(d), and 117(m), Internal Revenue Code of 1939 (26 U.S.C. Sections 22(a), 22(e), 115(d), and 117(m)). These provisions are set forth in Appendix A.

REGULATIONS:

The Treasury regulation involved is Section 29.117-11 of Regulations 111. This section is set forth in part in Appendix A.

STATEMENT

The taxpayers, C. D. Spangler (hereinafter referred to as taxpayer) and his wife, Veva C. Spangler, are residents of Charlotte, North Carolina. From 1949 until the present the taxpayer has been the principal officer and stockholder of C. D. Spangler Construction Company (hereinafter referred to as Construction Company), a corporation engaged in the general contracting business.

In 1949 taxpayer sponsored the incorporation of Double Oaks Apartments, Inc. (hereinafter referred to as Double Oaks). This corporation was formed to construct a low-rent housing project with funds obtained in part through a loan insured by the Federal

Housing Administration (FHA). The actual construction work was performed by Construction Company pursuant to a contract which provided for a fixed contract price. Such work was started in June, 1949. Some units were ready for occupancy by November, 1949, and the entire project was completed on or about January 23, 1950.

On May 24, 1950, Double Oaks' stock was held as follows:

Type of Stock	*No of Shares*	*Shareholder*
5% Preferred	100	FHA
Class A Common ($1 par)	100	Fred L. Taylor
Class A Common ($1 par)	300	Construction Company
Class B Common ($100 par)	886.4	Construction Company
Class B Common ($100 par)	2194.01	Taxpayer

The taxpayer's 2,194.01 shares of Class B Common stock were originally issued to a firm of Architects as a fee for services rendered in connection with the project. The taxpayer subsequently purchased such shares in August, 1949, for $16,570.

On May 24, 1950 the taxpayer surrendered 1,844.01 shares of his Double Oaks Class B Common stock to that corporation for redemption and received in exchange therefor the amount of $184,401 in cash. On that same date Double Oaks also redeemed and cancelled for $75,000 in cash 750 shares of the Class B Common stock owner by Construction Company.

On or about November 2, 1950 Double Oaks redeemed the 100 shares of its Class A common stock owned by Fred L. Taylor for $100.00, and on December 20, 1950, it redeemed the remaining 350 shares of its Class B Common stock owned by taxpayer for $35,000.

At the time of each stock redemption Double Oaks had no accumulated earnings or profits. For the fiscal years ended May 31, 1950 and May 31, 1951, it had net operating losses of $19,980.36 and $65,354.44, respectively. With the exception of a one month taxable period ending in 1952 for which a net profit of $352.92 was reported, Double Oaks' tax returns for subsequent taxable years through June 30, 1957 also consistently disclose net operating losses.

The funds available to Double Oaks for redemptions of its stock consisted of amounts received as consideration for the initial issue of its stock, a refund from Construction Company on the construction contract, and rents and deposits collected from tenants.

In 1950 the taxpayer also sponsored a second FHA low-rent housing project. The corporation which constructed this project (hereinafter referred to as Newland Road) originally issued 148.03 shares of Class B Common stock in payment for architectural services, and taxpayer later purchased such shares for $1,000. The shares so acquired were redeemed on December 20, 1950 by Newland Road for $14,803.00. On December 31, 1950 Newland Road had no accumulated earnings or profits, and it had for the fiscal year ended on that date, a net operating loss of $3,579.55. Its tax returns for subsequent years through June 30, 1957, also disclose a net operating loss in each year.

Construction Company remains today the principal stockholder of both Double Oaks and Newland Road.

Upon redemption of his shares of Class B Common stock of Double Oaks and Newland Road in 1950, the taxpayer had a gain of $216,634, and on the joint income tax return filed by the taxpayer and his wife for that year such gain was disclosed as a long-term

capital gain. In a statutory notice of deficiency mailed on February 16, 1954, the Commissioner of Internal Revenue determined that such gain was "taxable under Section 22(a) of the Internal Revenue Code" and not as a long-term capital gain.

On September 23, 1950, Section 117(m), Internal Revenue Code of 1939, relating to collapsible corporations, was enacted. Such statute provides that under certain conditions any gain from a sale or exchange of stock (a capital asset) by a shareholder, prior to the realization by the corporation issuing such stock of a substantial part of the net income to be derived from constructed property shall be considered as gain from the sale or exchange of property which is not a capital asset. The statute was retroactively applicable to all gains realized from the sale or exchange of stock subsequent to December 31, 1949.

Within 90 days after issuance of the notice of deficiency, the taxpayer and his wife appealed to the Tax Court of the United States for a redetermination of the deficiency asserted by the Commissioner. About two months prior to the hearing of such appeal in January, 1958 the Commissioner by amended pleadings asserted for the first time that Double Oaks and Newland Road were collapsible corporations and that, as a result, the gains realized by taxpayer upon the disposition of his stock in those corporations were taxable as ordinary income. This contention of the Commissioner was adopted and approved by the Tax Court and on appeal by the United States Court of Appeals for the Fourth Circuit. The taxpayer's 1950 income tax return was filed with the Collector of Internal Revenue for the District of North Carolina, and jurisdiction of the latter Court was invoked under Section 7482, Internal Revenue Code of 1954.

REASONS FOR GRANTING THE WRIT

I. DEPRIVATION OF PROPERTY WITHOUT DUE PROCESS OF LAW

(a) Denial of Motions by Tax Court

Section 117(m), Internal Revenue Code of 1939, was enacted on September 23, 1950, and the Treasury Regulations interpreting such section were issued two and one-half years later on March 26, 1953. The income tax deficiency here at issue was determined on February 16, 1954 and was initially predicated upon the ground that the taxpayer's gain upon redemption of Double Oaks and Newland Road stock was taxable as ordinary income under Section 22(a), Internal Revenue Code of 1939, and was not taxable as a long term capital gain as claimed on taxpayer's 1950 return. The applicability of Section 117(m) was not asserted until November 13, 1957, at which time, just two months before trial in the Tax Court, the Commissioner amended his pleadings to allege that such statute supported the deficiency he had determined.

Relying on the Tax Court's prior decision in *Thomas Wilson* (1956), 25 T.C. 1058, which case involved identical circumstances, the taxpayer took the position in the Tax Court that the burden of proof to establish the application of Section 117(m) rested upon the Commissioner of Internal Revenue. However, the Tax Court in the case at bar expressly overruled its prior decision in the *Wilson* case and sustained the deficiency upon the ground that the taxpayer failed to show that the gain in controversy was not taxable as ordinary income under Section 117(m). Although the question of where the burden of proof rested was raised at the outset of the hearing in the Tax Court, there was no ruling on the question until the Tax Court promulgated its final opinion which disposed of the entire controversy.

Promptly after the Tax Court promulgated its opinion and its new position on the burden of proof question became known, the taxpayer filed appropriate motions with the Tax Court requesting leave to question the constitutionality of the retroactive application of Section 117(m) to the distribution by Double Oaks to petitioner on May 24, 1950. The Tax Court denied such motions without a hearing, and on appeal the Court of Appeals affirmed the Tax Court's action primarily upon the ground that there was no sufficient reason for taxpayer's failure to raise the constitutional issue at the Tax Court hearing.

It is urged that the denial of taxpayer's motions by the Tax Court and the Court of Appeals was a clear abuse of discretion since such denial prevents the taxpayer from presenting a defense which in the interest of justice should be considered before the taxpayer is compelled to pay a tax of $94,832.44 on a retroactive determination by Congress and the Commissioner that a capital gain transaction resulted in ordinary income. *Bankers Pocahontas Coal Co.* v. *Burnet* (1932), 287 U.S. 308; *Helvering* v. *Edison Securities Corp.* (C.C.A. 4, 1935), 78 F. 2d 85; *Buffaloe Union Furnace Co.* v. *Helvering* (C.C.A. 2, 1934), 72 F. 2d 399; Cf. *Helvering* v. *Rankin* (1935), 295 U.S. 123. Further, it is submitted that the defense was raised timely in the Tax Court and that both the Tax Court and the Court of Appeals have erred in strictly applying a procedural concept to defeat the ends of justice. *Hormel* v. *Helvering* (1941), 312 U.S. 552.

(b) Retroactivity of Taxing Statute

Section 117(m) introduced an entirely new concept in income taxation by providing that a gain upon a dis-

tribution by a collapsible corporation shall be treated as a short term capital gain (ordinary income) even though such gain would otherwise be taxed as a long term capital gain. This provision, enacted September 23, 1950, was made effective with respect to any gain realized after December 31, 1949, and the Tax Court held such provision to be applicable to taxpayer's gain on the distribution by Double Oaks on May 24, 1950. This retroactive application of a new taxing concept to a voluntary, irrevocable transaction, completed prior to the enactment of such concept, violates the provisions of Amendment V of the Constitution of the United States, relating to the taking of property without due process of law.

In May 1950 the taxpayer, who controlled Double Oaks' activities, voluntarily caused that corporation to redeem 750 shares of its stock owned by Construction Company and 1844.01 shares of its stock that he owned. At the time of these voluntary transactions, any gain realized therefrom clearly qualified as a long term capital gain. Under the statutes then applicable the corporate distributions were not dividends (ordinary income) because Double Oaks had no earnings and profits. Instead, such distributions were controlled by Section 115(d), Internal Revenue Code of 1939, which provides that all distributions which are not dividends are taxable as long term capital gains to the extent that such distributions exceed the taxpayer's adjusted basis in his stock. See *Commissioner of Internal Revenue* v. *Gross* (C.A. 2, 1956), 236 F. 2d 612, involving similar distributions during years prior to 1950 and the effective date of Section 117(m).

When Congress enacted Section 117(m) in September, 1950, and made its provisions effective with respect

to gains realized after December 31, 1949, its action was clearly within the rule of the decisions of this Court in *Untermyer* v. *Anderson* (1928), 276 U.S. 440, and *Blodgett* v. *Holden* (1928), 275 U.S. 142, wherein it was held that a taxing statute enacted in June, 1924, was unconstitutional insofar as it undertook to impose a gift tax upon transfers made by taxpayers in January and May 1924. Such decisions are based upon the rationale that at the time of the voluntary acts which the statute later made a taxable event, the taxpayers could not reasonably have anticipated the nature or amount of the tax. See, e.g. *Nichols* v. *Coolidge* (1927), 274 U.S. 531, 542; and *Coolidge* v. *Long* (1931), 282 U.S. 582.

The instant taxpayer, through his affidavit accompanying the motion for further trial, has made a *prima facie* showing that the Double Oaks distribution on May 24, 1950 was completely voluntary and that, if it had been known on that date that any gain on the distribution would be taxable as ordinary income, he would not have caused Double Oaks to make the distribution nor would he have surrendered his stock for cancellation. Therefore, since the taxpayer might freely have chosen to cause or not to cause the May 24, 1950 distribution, the taxation of his gain therefrom as a short term capital gain after the choice had been made, which choice the taxpayer would have rejected had the tax consequences later enacted been known, was so arbitrary and oppressive as to be a denial of due process.

The instant case does not fall within the ambit of these decisions wherein this Court has upheld the constitutionality of a retroactive taxing statute which merely increased the rate of taxation. See, e.g., *Brush-*

aber v. *Union Pacific Railroad Co.* (1916), 240 U.S. 1; *Stockdale* v. *Atlantic Insurance Companies of New Orleans* (1873), 20 Wall. 323; *Welch* v. *Henry* (1938), 305 U.S. 134. Here, there is not simply an increase in a rate of tax but rather a taxing for the first time at ordinary income rates of a distribution by a corporation which theretofore had been taxed under the concept of capital gains. The retroactive conversion by a taxing statute of capital gains into ordinary income constitutes a change in nature of the tax which could not have been anticipated by the taxpayer at the time of the voluntary distribution and should be declared to be an unconstitutional invasion of taxpayer's rights. Cf. *Welch* v. *Henry*, *supra*. If the decisions of this Court can be construed, and taxpayer strongly urges that they can not be, to permit such an invasion, then the taxpayer respectfully submits that such decisions should be reviewed and reconsidered in the light of the present tax structure and confiscatory tax rates and that the scope of such decisions should be limited if not overruled.

The Court of Appeals brushed aside lightly taxpayer's argument regarding the unconstitutional nature of the retroactive provisions of Section 117(m) and stated that such "argument is fully answered by a recent decision of our brethren of the Second Circuit in a case not unlike the present one. *Sidney* v. *Commissioner*, 273 F. 2d 928 (2nd Cir., 1960)." In the *Sidney* case the taxpayer's argument with respect to retroactivity was related to his inability to have the view prescribed by Section 117(m) prior to enactment of that section. Although in that case there was a distribution in 1950 prior to the enactment of Section 117(m), the taxpayer's contention there was concerned

with the existence of the prerequisite view and did not concern the validity of the statute's retroactive application to the distribution. It is, therefore, urged that the *Sidney* decision did not involve the question which the instant case presents.

II. REGULATIONS PROMULGATED UNDER SECTION 117(m), INTERNAL REVENUE CODE OF 1939

(a) Regulations Were Not a Contemporaneous Construction of Section 117(m)

Section 117(m) of the 1939 Code was added by the Revenue Act of 1950, effective for taxable years ending after December 31, 1949. It was not until March 26, 1953, however, that the Commissioner's Regulations were promulgated. They were published in the Federal Register of April 2, 1953, as T.D. 5999.

In their respective opinions the Court of Appeals and the Tax Court cited *Fawcus Machine Co.* v. *United States* (1931), 282 U.S. 375, 387, and stated that since the Regulations as issued constituted a contemporaneous construction by those responsible for administration of the statute, such regulations should not be overruled except for weighty reasons. This rationale is unquestionably fallacious because no regulation issued almost three years after enactment of the statute can be considered "contemporaneous", the commonly accepted definition of that term being something "existing or occurring at the same time". Moreover, it is apparent that in the long interval between enactment of Section 117(m) and promulgation of the Regulations, there was ample opportunity for the Commissioner to deliberately consider and study the limited provisions of the statute, and the taxpayer submits that, as corroborated by the Senate Finance Committee Report accompanying the Internal Revenue

Code of 1954, it is no mere coincidence that the "collapsible corporation" statute, Section 117(m) of the 1939 Code, was broadened considerably in Section 341 of the 1954 Code and that such change in scope coincides with the Commissioner's interpretation of the prior statute as set forth in the 1953 Regulations.

(b) Regulations Under Section 117(m) of the 1939 Code Are Invalid

In the opinions below, Section 117(m) was held to apply to corporate distributions under Section 115(d) and inferentially to distributions governed by Section 22(c) of the 1939 Code. Taxpayer submits that this holding was improper in that there is no provision in the 1939 Code or statement in the Committee Reports relative to Section 117(m), which indicates that Section 117(m) was incorporated in Section 115(d) or intended to cover distributions under Section 115(d).

The only support for the holding below is found in the Commissioner's regulations promulgated under Section 117(m). These regulations in Section 29.117-11(a) specifically provide that the collapsible corporation provisions of Section 117(m) extend to and include distributions under Section 115(d). It is the taxpayer's position that such extension of the provisions of Section 117(m) to distributions under Section 115(d) constitutes an improper and invalid interpretation of Section 117(m) which is not warranted by the unambiguous language of the statute. Cf. *Trust of Bingham* v. *Commissioner of Internal Revenue* (1945), 325 U.S. 365; *Social Security Board* v. *Nierotko* (1945), 327 U.S. 358.

The taxpayer's position is supported by the legislative history of the 1954 Code relating to the col-

lapsible corporation provisions which discloses that the statutory counterpart of the Regulations under the 1939 Code was codified for the first time in subsection (a)(3) of Section 341 of the 1954 Code. Senate Report No. 1622, 83rd Congress, 2d Session, in explaining the technical provisions of the collapsible corporation sections of the 1954 Code states as follows (Pages 260-261):

> "Your committee's approach to the collapsible corporation problem is to return to existing law and to continue Section 117(m) for the future. *Your committee writes into the section a provision now appearing in the regulations under this section and makes two substantial changes with a view to strengthening its effectiveness.*"
>
> "Subsection (a)(3) *incorporates a rule of present regulations* that would include gain from a distribution made by a collapsible corporation which under Section 301(c)(3)(A) is treated (to the extent it exceeds stock basis) as a gain from the sale or exchange of property and would provide that such excess be treated as the gain from the sale of property which is not a capital asset. This provision would apply, for example, in the case of a corporation engaged in building, and otherwise meeting the tests of a collapsible corporation, *which distributes the proceeds of a loan in excess of the adjusted basis* of the property by which the loan is secured. *This rule supplements that previously described which appears in Section 312(j) of your committee's bill, relating to loans insured by the United States. Just as under Section 312(j), no inference is intended with respect to the status of present law by reason of the insertion into the statute of this rule.*" (emphasis supplied).

The italicized portions of the foregoing quotation clearly reveal that prior to enactment of the 1954 Code, there was no statutory support for the provisions in the Regulations which extended the application of Section 117(m) to distributions under Section 115(d). Section 115(d) of the 1939 Code was not in any way effected by the enactment of Section 117(m), but it was effected by the enactment of Section 341 (a)(3) of the 1954 Code which brought within the collapsible corporation provisions a distribution (to the extent it exceeds stock basis) which is not a dividend. Thus, to the extent that the 1939 regulations attempt to include within the ambit of the collapsible corporation provisions a distribution under Section 115(d), it is submitted that such regulations are without statutory support and are arbitrary and invalid.

Another important respect in which the Regulations lack statutory support is the almost conclusive effect which they provide for treating as "collapsible" any corporation which obtains a loan in excess of the adjusted basis of property and thereafter makes a distribution to its shareholders. Such effect is supplied by Example 1 of Section 29.117-11(e) which has uniformly been so applied by the Tax Court as well as the reviewing Courts. However, the plain language of the Senate Finance Committee Report discloses that for the first time the 1954 Code in Sections 312(j) and 341(a)(3) enacted into law this rule which formerly was found only in the Regulations.

III. NET INCOME OF DOUBLE OAKS AND NEWLAND ROAD

Section 117(m) imposes a tax at ordinary income rates on corporate distributions to a shareholder which occur prior to the earning of *net* income by the cor-

poration. The philosophy dictating the enactment of this section concerned the fact that the corporation, if allowed to operate, would have net income and any distribution after net income had been earned would be a dividend. Congress, recognizing that some corporations were making distributions before the corporations had any earnings, was concerned with the fact that earnings were being distributed before they were earned and that what would later be dividend income was being converted into a long term capital gain.

Inherent in the thinking of Congress and explicit in the statutory language is the requisite that the corporation must at some time have *net* income. Where, as in the case at bar, it has been determined that the distributing corporations over a seven-year period have had no net income there is no occasion to apply the provisions of Section 117(m).

The Tax Court, though not recognizing this principle in its opinion, did recognize it in *James B. Kelley* (1959) 32 T.C. 135. In that case that court held, in determining what is "a substantial part of the net income to be derived from such property," that consideration must be given to the net income realized by the corporation prior to any distribution and to the whole of the net income which can reasonably be anticipated will be derived from such property. The Court carefully pointed out that the concern is not with gross receipts but with net profits. In the case at bar, both corporations have had substantial losses since their beginning and there is no indication that either corporation will ever realize a net income.

The Court of Appeals and the Tax Court rejected this contention by observing that the net income to be

realized from the properties would consist of rental income over the life of the properties. This obviously supplies no answer to the problem since rental income to be received is *gross* income and not *net* income as required by Section 117(m)(2)(A)(i). At the time of the trial neither corporation had ever earned any net income, and it is mere speculation to hold that either will ever have any net income. Obviously, as the years pass, the corporations' interest and depreciation expenses will decline but it can not be surmised therefrom that the corporations will realize *net* income because rental income will decrease and repair expenses will increase in these years.

The taxpayer submits, therefore, that since it has been shown that neither Double Oaks nor Newland Road have ever had any *net* income and only through speculation can it be said that either corporation will ever have any *net* income, the application of Section 117(m) to distributions by those corporations constitutes an arbitrary and invalid interpretation of that section in contravention of Amendment V of the Constitution.

CONCLUSION

Each of the matters presented in this petition merit serious consideration. They represent important Federal questions which have not, but should be, examined and considered by this Court. A decision by this Court in these important areas will materially affect a large number of taxpayers as evidenced by the numerous collapsible corporation cases the Circuit Courts have been called upon to decide in recent years (App. 57a). Congress, in exercising its power to levy taxes, should

not be permitted to reach back and legislate with respect to closed voluntary acts of a taxpayer, and the Commissioner of Internal Revenue and the courts below, in interpreting and applying a taxing statute, should not be permitted to extend the scope of the law beyond the clear language of the statute and the expressed intent of the Congress.

Respectfully submitted,

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APPENDIX

APPENDIX A

Statutes and Regulations

Internal Revenue Code of 1939:

SECTION 22(a)—GROSS INCOME.

"(a) *General Definition*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

SECTION 22(e)

"*Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in Section 115."

SECTION 115(d)

"*Other distributions from capital.* If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in Section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. * * *"

Revenue Act of 1950, Approved September 23, 1950, Public Law 814:

SECTION 212. TREATMENT OF GAIN TO SHAREHOLDERS OF COLLAPSIBLE CORPORATIONS.

"(a) *Collapsible Corporations.*—Section 117 (relating to capital gains or losses) is hereby amended by adding after subsection (1) (added by section 211(a) of this Act) the following new subsection:"

"(m) *Collapsible Corporations.*—

"(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

"(2) Definitions.—

"(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

"(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

"(ii) the realization by such shareholders of gain attributable to such property.

"(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced property, if—

"(i) it engaged in the manufacture, construction, or production of such property to any extent,

"(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

"(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

"(3) Limitations on Application of Subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

"(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

"(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

"(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants."

"(b) Effective Date.—The amendment made by this section shall be applicable to taxable years ending after December 31, 1949, but shall apply only with respect to gain realized after such date. The determination of the tax treatment of gains realized prior to January 1, 1950, shall be made as if this section had not been enacted and without inferences drawn from the fact that the amendment made by this section is not expressly made applicable to gains realized prior to such date and without inferences drawn from the limitations contained in section 117(m), added to the Internal Revenue Code by this section."

Regulations of Commissioner Promulgated in T.D. 5999, Approved March 26, 1953.

REG. 111, SEC. 29.117-11. COLLAPSIBLE CORPORATIONS.—(a) *In general.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, and subject to the limitations contained in (c) hereof, the entire gain from (1) the actual sale or exchange of stock of a collapsible corporation, (2) amounts distributed in complete or partial liquidation of a collapsible corporation which are treated, under section 115(c), as payment in exchange for stock, and (3) a distribution made by a collapsible corporation which, under section 115 (d), is treated, to the extent it exceeds the basis of the stock, in the same manner as a gain from the sale or exchange of property, shall be considered as gain from the sale or exchange of property which is not a capital asset.

(b) *Determination of collapsible corporation.*—With respect to taxable years ending after December 31, 1949, but only with respect to gain realized after such date, a collapsible corporation is defined by section 117 (m) (2) (A) to be a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of

stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property. With respect to taxable years ending after August 31, 1951, but only with respect to gain realized after such date, the definition of a collapsible corporation under section 117 (m) (2) (A) is expanded to include a corporation formed or availed of principally for the purchase of property which (in the hands of the corporation) is properly described in section 117 (a) (1) (A), or for the holding of stock in a corporation so formed or availed of, with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation purchasing the property of a substantial part of the net income to be derived from such property, and (2) the realization by such shareholders of gain attributable to such property.

See (d) of this section for a description of the facts which will ordinarily be considered sufficient to establish whether or not a corporation is a collapsible corporation under the rules of this section. See (e) of this section for examples of the application of section 117 (m).

Under section 117 (m) (2) (A), the corporation must be formed or availed of with a view to the action therein described, that is, the sale or exchange of its stock by its shareholders, or a distribution to them prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and the realization by the shareholders of gain attributable to such property. This requirement is satisfied in any case in which such action was contemplated by those persons in a position to determine the policies of the corporation.

whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The requirement is satisfied whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of, it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view. See, however, the limitation contained in (c) (2) hereof. The existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of with a view to the action described in section 117 (m) (2) (A).

A corporation is formed or availed of with a view to the action described in section 117 (m) (2) (A) if the requisite view existed at any time during the manufacture, production, construction, or purchase referred to in that section. Thus, if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been so formed or availed of. However, if the sale, exchange, or distribution is attributable to circumstances present at the time of the manufacture, construction, production, or purchase, the corporation shall, in the absence of compelling facts to the contrary, be considered to have been so formed or availed of.

The property referred to in section 117 (m) (2) (A) is that property or the aggregate of those properties with respect to which the requisite view existed. In order to

ascertain the property or properties as to which the requisite view existed; reference shall be made to each property as to which, at the time of the sale, exchange, or distribution referred to in section 117 (m) (2) (A), there has not been a realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property. However, where any such property is a unit of an integrated project involving several properties similar in kind, the determination whether the requisite view existed shall be made only if a substantial part of the net income to be derived from the project has not been realized at the time of the sale, exchange, or distribution, and in such case the determination shall be made by reference to the aggregate of the properties constituting the single project.

A corporation shall be deemed to have manufactured, constructed, produced, or purchased property if it (1) engaged in the manufacture, construction, or production of property to any extent, or (2) holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, produced, or purchased the property, or (3) holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, produced, or purchased by the corporation. Thus, under (1), for example, a corporation need not have originated nor have completed the manufacture, construction, or production of the property. Under (2), for example, if an individual were to transfer property constructed by him to a corporation in exchange for all of the capital stock of such corporation, and such transfer qualifies under section 112 (b) (5), then the corporation would be deemed to have constructed the property, since the basis of the property in the hands of the corporation would, under section 113 (a) (8), be determined by reference to the basis of the property in the hands of the

individual. Under (3), for example, if a corporation were to exchange property constructed by it for property of like kind constructed by another person, and such exchange qualifies under section 112 (b) (1), then the corporation would be deemed to have constructed the property received by it in the exchange, since the basis of the property received by it in the exchange would, under section 113 (a) (6), be determined by reference to the basis of the property constructed by the corporation.

In determining whether a corporation is a collapsible corporation by reason of the purchase of property, it is immaterial whether the property is purchased from the shareholders of the corporation or from persons other than such shareholders. The property, however, must be property which, in the hands of the corporation, is property of a kind described in section 117 (a) (1) (A). Section 117 (a) (1) (A) describes the following property: stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. The determination whether property is of a kind described in section 117 (a) (1) (A) shall be made without regard to the fact that the corporation is formed or availed of with a view to the action described in section 117 (m) (2) (A).

Section 117 (m) is applicable whether the shareholder is an individual, a trust, an estate, a partnership, a company, or a corporation.

(e) *Limitations on application of section*—(1) *General.*—This section shall apply only to the extent that the recognized gain of a shareholder upon his stock in a collapsible corporation would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than six months. Thus, if a

taxpayer sells at a gain stock of a collapsible corporation which he has held for six months or less, this section would not, in any event, apply to such gain. Also, if it is determined, under provisions of law other than section 117 (m), that a sale or exchange at a gain of stock of a collapsible corporation which has been held for more than six months results in ordinary income rather than long-term capital gain, then this section (including the limitations contained herein) has no application whatsoever to such gain.

* * * * * * * * * * *

(3) *Seventy-percent rule.*—This section shall apply to the gain recognized during a taxable year upon the stock in a collapsible corporation only if more than 70 percent of such gain is attributable to the property referred to in section 117 (m) (2) (A). If more than 70 percent of such gain is so attributable, then all of such gain is subject to this section, and, if 70 percent or less of such gain is so attributable, then none of such gain is subject to this section.

For the purpose of this limitation, the gain attributable to the property referred to in section 117 (m) (2) (A) is the excess of the recognized gain of the shareholder during the taxable year upon his stock in the collapsible corporation over the recognized gain which the shareholder would have if the property had not been manufactured, constructed, produced, or purchased. In the case of gain on a distribution in partial liquidation or a distribution described in section 115 (d), the gain attributable to the property shall not be less than an amount which bears the same ratio to the gain on such distribution as the gain which would be attributable to the property if there had been a complete liquidation at the time of such distribution bears to the total gain which would have resulted from such complete liquidation.

Gain may be attributable to the property referred to in section 117 (m) (2) (A) even though such gain is represented by an appreciation in the value of property other

than that manufactured, constructed, produced, or purchased. Where, for example, a corporation owns a tract of land and the development of one-half of the tract increases the value of the other half, the gain attributable to the developed half of the tract includes the increase in the value of the other half.

* * * * * * * * * * *

(d) *Application of section.*—(1) Whether or not a corporation is a collapsible corporation shall be determined under the rules of (b) of this section on the basis of all the facts and circumstances in each particular case. The following paragraphs set forth those facts which will ordinarily be considered sufficient to establish that a corporation is or is not a collapsible corporation. The facts set forth in the following paragraphs are not exclusive of other facts which may be controlling in any particular case. For example, if the facts in paragraph (2), but not the facts in paragraph (3), are present, the corporation may nevertheless not be a collapsible corporation if there are other facts which clearly establish that the rules of (b) of this section are not satisfied. Similarly, if the facts in paragraph (3) are present, the corporation may nevertheless be a collapsible corporation if there are other facts which clearly establish that the corporation was formed or availed of in the manner described in (b) of this section, or if the facts in paragraph (3) are not significant by reason of other facts, such as the fact that the corporation is subject to the control of persons other than those who were in control immediately prior to the manufacture, construction, production, or purchase of the property.

See (e) of this section for provisions which make section 117 (m) inapplicable to certain shareholders of collapsible corporations.

(2) The following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1).

above, and paragraph (3), below) to establish that a corporation is a collapsible corporation:

(i) A shareholder of the corporation sells or exchanges his stock, or receives a liquidating distribution, or a distribution described in section 115 (d).

(ii) Upon such sale, exchange, or distribution, such shareholder realizes gain attributable to the property described below, and

(iii) At the time of the manufacture, construction, production, or purchase of the property described below, such activity was substantial in relation to the other activities of the corporation which manufactured, constructed, produced, or purchased such property.

The property referred to above is that property or the aggregate of those properties which meet the following two requirements:

(iv) The property is manufactured, constructed, or produced by the corporation or by another corporation stock of which is held by the corporation, or is property purchased by the corporation or by such other corporation which (in the hands of the corporation holding such property) is property described in section 117 (a) (1) (A) (relating to stock in trade, inventories, and property held primarily for sale to customers), and

(v) At the time of the sale, exchange, or distribution described in (i) above, the corporation which manufactured, constructed, produced, or purchased such property has not realized a substantial part of the net income to be derived from such property.

In the case of property which is a unit of an integrated project involving several properties similar in kind, the rules of this paragraph shall be applied to the aggregate

of the properties constituting the single project rather than separately to such unit. Under the rules of this paragraph, a corporation shall be considered a collapsible corporation by reason of holding stock in other corporations which manufactured, constructed, produced, or purchased the property only if the activity of the corporation in holding stock in such other corporations is substantial in relation to the other activities of the corporation.

(3) The absence of any of the facts set forth in paragraph (2) or the presence of the following facts will ordinarily be considered sufficient (except as otherwise provided in paragraph (1), above) to establish that a corporation is not a collapsible corporation:

(i) In the case of a corporation subject to the rules of paragraph (2) only by reason of the manufacture, construction, production, or purchase (either by the corporation or by another corporation the stock of which is held by the corporation) of property which is property described in section 117 (a) (1) (A), the amount (both in quantity and value) of such property is not in excess of the amount which is normal—

(A) For the purpose of the business activities of the corporation which manufactured, constructed, produced, or purchased the property if such corporation has a substantial prior business history involving the use of such property and continues in business, or

(B) For the purpose of an orderly liquidation of the business if the corporation which manufactured, constructed, produced, or purchased such property has a substantial prior business history involving the use of such property and is in the process of liquidation.

(ii) In the case of a corporation subject to the rules of paragraph (2) with respect to the manufacture, con-

struction, or production (either by the corporation or by another corporation the stock of which is held by the corporation) of property, the amount of the unrealized net income from such property is not substantial in relation to the amount of the net income realized (after the completion of a material part of such manufacture, construction, or production, and prior to the sale, exchange, or distribution referred to in paragraph (2) (i)) from such property and from other property manufactured, constructed, or produced by the corporation.

(e) *Examples.*—The following examples will illustrate the application of this section:

EXAMPLE (1). On January 2, 1951, A formed the W corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be

derived from such building, and since the construction of the building was a substantial activity of the corporation, the W corporation is considered a collapsible corporation under (d) (2) of this section. The provisions of section 117(m)(3) do not prohibit the application of section 117(m)(1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117(m), will be considered ordinary income under section 117m)(1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (b) and (d)(1) of this section.

* * * * * * * * * * *

EXAMPLE (4). On January 2, 1947, C formed the Y corporation and became the sole shareholder thereof. The Y corporation has been engaged solely in the business of producing motion pictures and licensing their exhibition. On January 2, 1952, C sold all of the stock of the Y corporation at a gain. The Y corporation has produced one motion picture each year since its organization and prior to January 2, 1952, it has realized a substantial part of the net income to be derived from each of its motion pictures except the last one made in 1951. This last motion picture was completed September 1, 1951. As of January 2, 1952, no license had been made for its exhibition. The fair market value on January 2, 1952, of this last motion picture exceeds the cost of its production by $50,000. A material part of the production of this last picture was completed on January 1, 1951, and between that date and January 2, 1952, the corporation had realized net income of $500,000 from other motion pictures produced by it. The corporation has consistently distributed to its shareholder its net income when received (after adjustment for taxes).

Although the corporation is within (d) (2) of this section with respect to the production of property, the amount

of the unrealized net income from such property ($50,000) is not substantial in relation to the amount of the net income realized, after the completion of a material part of the production of such property and prior to sale of the stock, from such property and other property produced by the corporation ($500,000). Accordingly, the Y corporation is within (d) (3) (ii) of this section, and is not considered a collapsible corporation.

EXAMPLE (5). The facts are the same as in example (4) except that C sold all of his stock to D on February 1, 1951. On January 2, 1952, D sold all of the Y corporation stock at a gain, the gain being attributable to the picture completed September 1, 1951, and not released by the corporation for exhibition. In view of the change of control of the corporation, the provisions of (d) (3) (ii) are not significant at the time of the sale by D, and the Y corporation would be considered a collapsible corporation on January 2, 1952. See (b) and (d) (1) of this section. [Reg. 111, Sec. 29.117-11.]

APPENDIX B

Findings of Fact and Opinion of Tax Court of the United States

32 T.C. No. 67

(Caption Omitted)

Docket No. 52776 Filed June 30, 1959

(Headnote Omitted)

ATKINS, *Judge:* The respondent determined a deficiency in income tax for the year 1950 in the amount of $94,832.44. The issue is whether the gain derived by the petitioners upon the redemption of class B stock of Double Oaks Apartments, Inc., and Newland Road Apartments, Inc., in the year 1950 is long-term capital gains as reported by the petitioners or whether it is taxable under section 117(m) of the Internal Revenue Code of 1939 as gain from the sale or exchange of property which is not a capital asset, as contended by the respondent. A question is also raised as to the basis of the stock.

FINDINGS OF FACT

Most of the facts are stipulated and the stipulations are incorporated herein by this reference.

The petitioners are husband and wife, residing at Charlotte, North Carolina. For the taxable year ended December 31, 1950, the petitioners' joint income tax return was filed with the collector of internal revenue for the district of North Carolina. C. D. Spangler will be sometimes referred to as the petitioner.

C. D. Spangler Construction Company (hereinafter referred to as Construction Company) is a North Carolina corporation engaged in the general contracting business. From 1949 until the present time all of its outstanding capital stock has been owned and held 51 per cent by the petitioner and 49 per cent by members of his immediate family.

Facts as to Double Oaks Project

On February 28, 1949, the Federal Housing Commissioner entered into a commitment for mortgage insurance, pursuant to section 608 of the National Housing Act, in the amount of $2,233,700, repayable over a period of about 33 years, for a rental housing project to be built in Charlotte, North Carolina. A mortgagee bank was named therein, the petitioner was designated as the sponsor, and the mortgagor was Double Oaks Apartments, Inc. (hereinafter called Double Oaks), a proposed or prospective corporation. The amount of the commitment was computed by the FHA by deducting from $2,483,762 (being 90 per cent of the stated total replacement cost of the property) an amount of $250,000, the stated fair market price of the land.

In the commitment it was required as a condition to insuring the loan that at time of closing, the mortgagee bank furnish evidence of the collection by it of certain specified sums, including an escrow deposit to cover so-called off-site utilities and streets in the amount of $210,108. Under the FHA requirements, off-site improvements must be financed independently of the insured loan. It was provided in the commitment that a contract between the sponsor of the project and a contractor acceptable to the Commissioner might be presented in lieu of the escrow agreement and cash escrow deposit. The so-called off-site improvements consisted principally of curbs, gutters, and pavements on the project and adjacent streets, a sanitary sewer system on all streets within the project boundary, a water system on all streets within the project boundary and connecting with the city water line, and a storm sewer system.

On June 15, 1949, the petitioner, as sponsor, entered into a contract with Construction Company, whereby he agreed to pay Construction $210,108 upon final completion of the off-site improvements. Construction Company furnished a bond for faithful performance, and the improvements were completed. Upon this contract the petitioner, at an undisclosed time, paid Construction Company an amount slightly

in excess of $49,000. The books of Double Oaks show that the corporation paid no amount on account of or for these improvements.

Double Oaks was organized under the laws of the State of North Carolina on May 10, 1949. The incorporators were the petitioners and Lee Wallace. Its charter stated that the object for which it was formed was to provide housing for rent or sale, to improve and operate, and to sell, convey, assign, mortgage or lease any real estate and any personal property. The charter provided that so long as any property of the corporation was encumbered by a mortgage or deed of trust insured by the Federal Housing Commissioner it should not engage in any business other than the construction and operation of a rental housing project or projects.

The authorized capital stock consisted of 100,000 shares of class A common stock having a par value of $1.00 per share, 3,999 shares of class B common stock having a par value of $100 per share, and 100 shares of preferred stock having a par value of $1.00 per share. The preferred stock carried the right to non-cumulative dividends at 5 cents per share before any dividend or distribution upon the common stock, the class B stock was entitled to non-cumulative dividends of 6 per cent out of current net earnings before payment of any dividends on the class A stock and had priority upon dissolution over the class A stock. The class B common stock could be retired at $100 per share after the payment of all interest and principal due and after making provision for payment of operating expenses, etc., and after the establishment of a reserve fund for replacements. The charter provided that no such stock could be retired until after the completion of the improvements on the property, or before the final endorsement for mortgage insurance by the Federal Housing Commissioner. The class A common stock had the exclusive voting privilege, except in the case of specified defaults, in which case the preferred stock had the right to elect directors. Upon liquidation the

class A common stock was entitled to the entire assets after the payment of the preferred stock and the class B common stock.

The certificate of incorporation also provided that the preferred stock might be retired and should be retired upon, but in no event before, the termination of any contract of mortgage insurance covering any indebtedness to which the FHA was a party. It was also provided that the corporation should not, without approval of the holders of the majority of the shares of the preferred stock, assign, transfer, dispose of, or encumber any real or personal property, including rents, except as permitted by the terms of the mortgage, and should not consolidate or merge with any other corporation, go into voluntary liquidation, effect any plan of reorganization, redeem or cancel any of its shares of preferred stock, or amend the certificate of incorporation.

On June 10, 1949, Double Oaks issued stock for cash at par as follows:

Type of Stock	Number of Shares	Name in Which Issued
5% Preferred	100	Federal Housing Administration
A Common	300	C. D. Spangler Construction Company
"	100	Fred L. Taylor
B Common	2,194.01	William G. Lyles, Bissett, Carlisle and Wolf (Architects)
"	136.4	C. D. Spangler Construction Company
"	750	Fred L. Taylor

Fred L. Taylor is an individual who resides at Pinehurst, North Carolina. He is not related by either blood or marriage to the petitioner and in 1949 and theretofore was not an employee of either the petitioner or Construction Company. On or about January 26, 1950, the 750 shares of class B common stock originally issued to Fred L. Taylor were acquired by Construction Company for $75,000. On May 24, 1950 Construction Company surrendered this stock to Double Oaks for redemption and received therefor $75,000 in cash. On or about November 2, 1950, the 100 shares of

class A common stock originally issued to Fred L. Taylor were redeemed for $100.

William G. Lyles, Bisset, Carlisle and Wolf was an architectural firm which maintained its principal office at Columbia, South Carolina. The FHA project analysis and commitment for Double Oaks contemplated that architect fees in the amount of $112,376 and builders' fees in the amount of $107,025, or a total of $219,401, would be paid in stock. The 2,194.01 shares of Double Oaks class B common stock, representing the aggregate architect and builders' fees was originally issued to the architects. On August 8, 1949, such 2,194.01 shares were sold to the petitioner for the amount of $16,570. Thereafter and until December 20, 1950, the petitioner owned more than 10 per cent in value of the outstanding stock of Double Oaks.

On June 10, 1949, Double Oaks acquired from the petitioner a ground lease for a term of 99 years on a tract of land containing approximately 69.14 acres located in Mecklenburg County, North Carolina, upon which land the rental units were to be built. The tenant agreed to pay a basic annual rental of $10,000 after the date of completion of the improvements and also agreed to pay all real estate taxes, water charges, sewer rents, and other assessments on the lessor's interest in the leased premises. It was recited in the lease that the tenant contemplated the construction on the premises of a low-cost rental housing project consisting of buildings and other incidental facilities with all appurtenances thereto. It was provided that the tenant should not demolish any improvements, except for repairs or replacements. The lessor agreed to join with the lessee in any grants for easements for electric, telephone, gas, water, sewer, and other public utilities or facilities as might be necessary in the operation of the demised premises or the improvements thereon. It was contemplated in the lease that the lessee would mortgage its leasehold interest. It was agreed that if no default existed the lessor would not accept a cancellation of the lease prior to termination with-

ent the consent of the mortgagee and, if the mortgage should be insured by the FHA, without the consent of the Federal Housing Commissioner. In the event of default by the lessee, the mortgagee and the FHA would be given notice and had the right to succeed to the rights of the lessee, or obtain a new lease. It was specifically provided that if the mortgagee or the Federal Housing Commissioner should acquire title to the leasehold interest they should have the option to purchase the fee title to the land for $250,000. This option to purchase did not extend to Double Oaks, the mortgagor.

On June 10, 1949, Double Oaks obtained a loan from a bank in the amount of $2,233,700, which was evidenced by a promissory note. To secure the loan of the bank, Double Oaks gave a deed of trust to the bank covering all the property, including the leasehold estate. The note provided that the first monthly payment on principal should be made on December 1, 1950. Advances were made by the bank on the loan as follows:

Date of Advance	Amount
6/23/49	$ 22,408.50
7/16/49	132,711.30
8/2/49	315,567.63
9/2/49	454,405.55
10/4/49	423,686.30
11/3/49	391,286.42
12/3/49	157,111.84
12/30/49	51,674.66
1/18/50	284,847.80

In the FHA commitment, Double Oaks agreed to make certain additional mortgage escrow deposits with the bank as a replacement fund. Deposits of $5,359.60 and $23,879.90 were made on May 31, 1950, and May 31, 1951, respectively.

The note of Double Oaks evidencing the loan of $2,233,700 was finally endorsed for mortgage insurance by the Federal Housing Commissioner on January 23, 1950.

Construction of the housing project began on or about June 10, 1949. On that date Double Oaks entered into a contract with Construction Company under which the latter agreed to build the project for a lump sum of $2,140,493. The contract provided that the petitioner should give an indemnity agreement in the amount of $223,370 to assure completion of the project. Such total amount was paid in several payments by Double Oaks over the period from June 1949 to January 1950. After all the payments were made, Construction Company paid Double Oaks on May 24, 1950, an amount of $171,239.44 as a refund on the construction contract. This amount had been set up on Double Oaks' books on February 28, 1950, as a refund due from Construction Company and the check by which payment was made also noted that it constituted payment of a note in full for refund on a construction contract. The books of Double Oaks show a journal entry of February 28, 1950, to record this amount as a refund due from Construction Company.

Some of the units were ready for occupancy in November 1949. Double Oaks collected, during the fiscal years ended May 31, 1950 and May 31, 1951, rents in the respective amounts of $115,308.99 and $230,012.77.

Double Oaks made the first payment of principal on its $2,233,700 loan on or about December 1, 1950. During the fiscal years ended May 31, 1950 and May 31, 1951, it paid interest on such loan in the respective amounts of $62,766.45 and $81,771.44.

On May 24, 1950, the petitioner surrendered 1,844.01 shares of class B common stock of Double Oaks to that corporation for redemption and received in exchange therefor the amount of $184,401 in cash. On December 20, 1950, he surrendered an additional 350 shares of class B common stock for redemption and received in exchange

therefor the amount of $35,000 in cash. The total of 2,194.01 shares so surrendered and redeemed were the same 2,194.01 shares that petitioner had purchased from William G. Lyles, Bissett, Carlisle and Wolf on August 8, 1949, at a cost of $16,570.

At June 30, 1950 and June 30, 1951, Double Oaks had no accumulated earnings and profits. Its tax returns were filed on an accrual basis. For the fiscal years ended May 31, 1950 and 1951 the returns showed net operating losses of $19,980.36 and $65,354.44, respectively. Its returns for subsequent years through June 30, 1957, also showed net losses except for a small profit in one short period.

The actual cash received by Double Oaks during its fiscal year ended May 31, 1950, amounted to $2,614,976.43, consisting of the following:

F. L. Taylor purchase of 750 shares Class B Stock		$ 75,000.00
C. D. Spangler Construction Co. purchase of 136.4 shares Class B Stock		13,640.00
U.S. Treasury-FHA purchase of 100 shares Preferred Stock		100.00
F. L. Taylor-payment of subscription for 100 shares Class A Stock		100.00
C. D. Spangler Const. Co.—payment of subscription for 300 shares Class A Stock		300.00
C. D. Spangler Const. Co.—refund		171,239.44
FHA insured loan (Wachovia Bank & Trust Company) proceeds		2,233,700.00
RECEIPTS OTHER THAN RENT & DEPOSITS		$2,494,079.44
Rents collected	$115,330.99	
Tenants' Security Deposits	5,566.00	120,896.99
TOTAL RECEIPTS		$2,614,976.43

The actual cash disbursements of Double Oaks during its fiscal year ended May 31, 1950, amounted to $2,603,808.47, consisting of the following:

Amount originally paid to Construction Co.	$2,140,493.00
Expenses Capitalized	107,227.55
Equipment Purchased	2,694.93
Operating Expenses	74,815.30
Mortgage Escrow Deposits	5,359.60
Prepaid Hazard Insurance	1,467.09
Prepaid Mortgage Insurance	12,350.00
Capital Stock Redeemed	259,401.00
	$2,603,808.47

In 1956, as a result of a requirement of the FHA in connection with the so-called windfall profit, Construction purchased at par 496.78 shares of the class B common stock of Double Oaks from that corporation for $49,678. In accordance with an agreement between the FHA and Double Oaks, $10,022.39 of this amount was to be paid on the mortgage indebtedness of Double Oaks and the balance of $39,655.61 was to be retained in the corporation treasury, its disposition to be later determined by conference with the FHA or by lawsuit.

Facts as to Newland Road Project

Sometime prior to February 28, 1950, the petitioner sponsored a second housing project at Charlotte, North Carolina. Newland Road Apartments, Inc., hereinafter referred to as Newland Road, was organized under the laws of the State of North Carolina on March 15, 1950, for the purpose of carrying out this second project. The incorporators of Newland Road were the petitioner, John D. Shaw, and James M. Poyner. The corporate charter was issued on March 21, 1950, and the pertinent provisions of such charter are identical with the provisions of the charter of Double Oaks.

The authorized capital of Newland Road was $300,000 divided into 100,000 shares of class A common stock with a par value of $1.00 per share, 1,999 shares of class B common stock with a par value of $100 per share, and 100 shares of 5 per cent non-cumulative preferred stock with a par value of $1.00 per share.

On April 1, 1950, Newland Road issued stock for cash as follows:

Type of Stock	Number of Shares	Name in Which Issued
Preferred	100	Federal Housing Administratio..
A Common	300	C. D. Spangler Construction Co.
B Common	148.03	William G. Lyles, Bissett, Carlisle and Wolf (Architects)

As in the case of Double Oaks, the petitioner was the sponsor of the Newland Road project, and the FHA committed itself to loan $824,000.

The FHA project analysis and commitment for Newland Road contemplated that architects' fees in the amount of $44,803 and builders' fees in the amount of $42,670, or a total of $87,473, would be paid. As indicated above, 148.03 shares of Newland Road class B common stock were originally issued to the architects. On May 26, 1950, Newland Road paid the architects $3,220 in cash; and on May 29, 1950, the petitioner purchased the 148.03 shares for $1,000. Thereafter, and until December 20, 1950, the petitioner individually owned more than 10 per cent in value of the outstanding stock of Newland Road.

As in the case of the Double Oaks project, the commitment was conditioned upon the completion of certain off-site improvements. On or about April 1, 1950, the petitioner and Construction Company entered into an agreement for the installation of such improvements by Construction Company for $12,945. Newland Road paid no amount on account of or for such off-site improvements.

In the FHA commitment it was required that at the time of closing, the mortgagee bank furnish evidence of

the collection of certain specified sums, including an escrow deposit to cover the so-called off-site improvements in the amount of $12,945.

On April 1, 1950, Newland Road acquired from the petitioner a ground lease, similar to that acquired by Double Oaks, at a basic annual rental of $1,760, for a term of 99 years on a tract of land containing approximately 17.75 acres located in Mecklenburg County, North Carolina, upon which land the rental units were to be built. As in the case of Double Oaks, the ground lease granted an option to purchase to the mortgagee or the Federal Housing Commissioner.

On the same date, Newland Road obtained a loan from a bank in Charlotte, North Carolina, in the amount of $824,000 which was evidenced by a promissory note. Such note provided that the first monthly payment on principal should be made on April 1, 1951. Advances were made by the bank on the loan as follows:

Date of Advance	Amount
4/8/50	$ 36,807.00
5/3/50	198,984.64
5/24/50	207,064.06
6/16/50	207,008.21
9/23/50	174,136.09
	$824,000.00

To secure the loan Newland Road executed a deed of trust in favor of the bank. As in the case of the Double Oaks property, the deed of trust given by Newland Road to the bank covered all of the Newland Road property, including the leasehold estate.

The note of Newland Road evidencing the loan of $824,000 made by the Bank to Newland Road was endorsed (final endorsement) for mortgage insurance by the Federal Housing Commissioner on October 16, 1950.

Newland Road made the first payment of principal on its $824,000 loan on or about April 1, 1951. Prior to December 31, 1950, Newland Road had paid a total of $13,916.41 as interest on such loan.

On or about April 1, 1950, Newland Road began construction of the rental housing project. On that date Construction Company entered into a contract to construct the buildings for a lump sum of $758,413, or cost plus $15,000, whichever was lower, and in addition 726.70 shares of the class B common stock of the corporation. The contract provided that the petitioner should give an indemnity agreement in the amount of $82,400 to assure completion of the project.

Newland Road made payments to Construction Company for "construction fee" as follows:

April, 1950	$ 12,000.00
May, 1950	297,000
June, 1950	204,000.00
July, 1950	100,000.00
September, 1950	145,413.00
	$758,413.00

Some units in the project were ready for occupancy in July 1950, and from the date of first occupancy to December 1950, the rents collected by Newland Road amounted to $35,258.45.

On December 20, 1950, Spangler surrendered 148.03 shares of class B common stock of Newland Road to that corporation for redemption and received in exchange therefor the amount of $14,803 in cash. The shares so surrendered and redeemed were the same shares that Spangler had purchased from William G. Lyles, Bissett, Carlisle and Wolf on May 29, 1950, at a cost of $1,000.

At December 31, 1950, Newland Road had no accumulated earnings and profits. Its tax returns were filed on an accrual basis. For the fiscal year ended December 31, 1950,

the return showed net operating losses of $3,579.55. Its returns for subsequent years through June 30, 1957, also showed net losses.

The actual cash received by Newland Road during its fiscal year ended December 31, 1950, amounted to $860,914.45, consisting of the following:

C. D. Spangler Construction Co.—payment for subscription to capital stock		$ 200.00
U.S. Treasury preferred stock		100.00
FHA mortgage receipts		824,000.00
TOTAL RECEIPTS OTHER THAN RENT OR OTHER BUSINESS OPERATIONS		$824,400.00
Rents collected	$34,556.45	
Tenants' Security Deposits	1,958.00	36,514.45
TOTAL RECEIPTS		$860,914.45

The actual cash disbursements of Newland Road during its fiscal year ended December 31, 1950, amounted to $860,017.27, consisting of the following:

Amount paid for depreciable assets	$787,139.70
Operating expenses	19,243.98
Mortgage escrow deposits	23,918.00
Prepaid items	1,912.59
Net loan to Construction Co.	13,000.00
Redemption of stock	14,803.00
Total	$860,017.27

In their joint income tax return for the year ended December 31, 1950, the petitioners reported long-term capital gain of $202,831 from the redemption of the class B common stock of Double Oaks and $13,803 from the redemption of the class B common stock of Newland Road.

In the notice of deficiency for the year 1950, the respondent stated:

It has been determined that Mr. Spangler realized during the taxable year ordinary income in the amount of $216,634.00 of which $202,831.00 was received with respect to 2,109.01 shares of Double Oaks Apartments, Inc., stock and $13,803.00 with respect to $148.03 [sic] shares of Newland Road Apartments stock.

It is held that this amount is taxable under the provisions of Section 22(a) of the Internal Revenue Code. Since you reported in your return for this year $108,317.50 (50% of $216,634.00) in respect to these transactions your net income has been increased by the amount of $108,317.00.

By amended answer filed November 13, 1957, the respondent alleged as follows:

In the statutory notice of deficiency, dated February 16, 1954, it was determined that the petitioners realized ordinary income within the provisions of section 22(a) of the Internal Revenue Code of 1939 in the amount of $216,634.00 in 1950, of which $202,831.00 was realized with respect to 2,194.01 shares of Double Oaks Apartments, Inc., stock and $13,803.00 with respect to 148.03 shares of Newland Road Apartments, Inc., stock. As an additional reason in support of the deficiency determined in the statutory notice of deficiency dated February 16, 1954, respondent asserts that ordinary income was realized by the petitioners with respect to the Double Oaks Apartments, Inc., transactions within the provisions of section 117(m) of the Internal Revenue Code of 1939 since both of said corporations are collapsible corporations within the provisions of that Code section.

Double Oaks and Newland Road were formed or availed of principally for the construction of properties with a view to the realization by the petitioner as a shareholder of gain attributable to the properties through distributions

to him as a shareholder or exchange of stock by him as a shareholder before the realization by the corporations of substantial parts of the net income to be derived from the properties.

OPINION

The petitioners reported the gain upon the redemption of the class B stock of Double Oaks and Newland Road as long-term capital gain, including in taxable income only one-half thereof. They contend that this is the proper treatment to be given to such gain. They point out that neither corporation had earnings and profits available for the payment of dividends and that hence the amounts distributed may not be taxed as dividends. They also contend that the distributions are governed by section 115(d) and that any gain is taxable at capital gain rates. But the real issue here is whether the gains realized are to be taxed, pursuant to section 117(m) of the Internal Revenue Code of 1939,[1] as gains from the sale or exchange of assets which are not capital assets.

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[1] Section 117(m), as applicable to the year 1950, provides in part as follows:

(m) Collapsible Corporations.—

(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) Definitions.—

(A) For the purposes of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production

Upon this issue the petitioners contend that the burden of proof is upon the respondent to show that all the prerequisites of section 117(m) are present, and their arguments on brief are based largely upon alleged failures of the respondent to show necessary factual matters. The petitioners are in error in their contention that the respondent has the burden of proof. In the notice of deficiency the respondent held that the gain upon the redemptions, and not the full amounts received in distribution, was

> of property, or for the holding of stock in a corporation so formed or availed of, with a view to—
>
> (I) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and
>
> (II) the realization by such shareholders of gain attributable to such property.
>
> (3) Limitations on Application of Subsection.—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—
>
> (A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;
>
> (B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and
>
> (C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

taxable under the provisions of section 22(a) of the Internal Revenue Code of 1939. In such notice he referred to the income as "ordinary income" but we attach no particular significance to this since, if the transaction did fall within section 117(m), such gain would be taxed as ordinary income as distinguished from capital gain. The respondent did not, in the notice of deficiency, state any particular reason for including this gain in income but relied generally upon section 22(a) which embraces "gains or profits and income derived from any source whatever." Under such a broad determination in the deficiency notice, he was free to advance section 117(m) in support of his determination without assuming the burden of proof. The fact that he amended his answer about two months prior to the hearing to rely specifically upon section 117(m) does not bring him within our Rule 32 relating to the pleading of new matter as to which the burden of proof is upon him. See *Leland D. Payne*, 30 T.C. 1044, on appeal (C.A. 5), and *Arthur Sorn*, 29 T.C. 959, on appeal (C.A. 2), and cases cited therein.

The case of *W. H. Weaver*, 25 T.C. 1067, cited by the petitioners, is not in point. There the respondent, in the notice of deficiency, held that the value of stock received by the taxpayer constituted compensation for services taxable under section 22(a). Later, by amended answer he raised an entirely new issue, resulting in application for increased deficiencies, based upon the assertion that the taxpayer was in receipt of income upon the redemption of stock, taxable under section 117(m).

The petitioners have also cited *Thomas Wilson*, 25 T.C. 1058, appeal dismissed (C.A. 4). There the taxpayers had sold some stock to third parties and had caused some of their stock to be redeemed by the corporations. The taxpayers in their returns treated the gain, and in some instances, where the basis was negligible, the entire amounts received, as long-term capital gain. In the notices of deficiency for the year 1950, the respondent stated that the

petitioners "realized during the taxable year ordinary income" in the amount received and stated that "It is held that this amount is taxable under the provisions of section 22(a) of the Internal Revenue Code." Therein the respondent did not refer to section 117(m) or any other section, except section 22(a). Thus, as is true in the instant case, he did not state any particular reason for his determination. Accordingly, no language employed in the deficiency notices directly or by necessary inferences excluded a reliance by the respondent upon section 117(m). In that case, it is true, the respondent in his notices of deficiency held that the full amounts received upon the dispositions of the stock was taxable as ordinary income, and did not allow any basis for the stock in his calculations. However, as we stated in *Arthur Sorin*, *supra*, section 117(m) would require taxation of the entire receipt if the basis of the stock was zero, and there is nothing in that section or elsewhere which relieves a taxpayer of the obligation of proving his basis or which prevents the respondent from assuming that the basis is zero in the absence of a contrary showing. Upon a careful re-examination of the *Wilson* case, we are of the opinion that our holding that the burden of proof was upon the respondent with respect to the section 117(m) issue was erroneous, and it will not be followed in the future.

The burden of proof is upon the petitioners, and they have not shown that the corporations were not collapsible corporations within the definition of section 117(m). Rather, we think the record establishes that they were. The pattern is similar to that which we considered in *Raymond G. Burge*, 28 T.C. 246, aff'd. (C.A. 4), 253 F. 2d 765, *R. A. Bruan*, 32 T.C. (April 16, 1959), and *W. H. Weaver*, 32 T.C. (May 29, 1959). Here the corporations were set up with two classes of common stock. Although the petitioner was not the record owner of any of such stock at the beginning he later acquired stock while the construction of the properties was in progress. Class

B common stock had been issued ostensibly as fees to the architects, but this was purchased by the petitioner at a small fraction of the par value thereof. In this connection we note that although the FHA commitment contemplated that a large amount of class B stock of Double Oaks would be issued to Construction Company as a construction fee, that corporation did not receive such stock. Rather, the architects received such stock, in addition to other stock, and it was the total amount of stock held by the architects which the petitioner later purchased and which was redeemed by the corporations at par.

The first redemption by Double Oaks was in May 1950, which was approximately 4 months after completion of construction. At that time the petitioner relinquished 1,844.01 shares of the class B stock and received $184,401. The second redemption was in December 1950, which was about 11 months after completion of construction. This involved 350 shares of class B stock for which the petitioner received $35,000.

In the case of Newland Road the petitioner transferred to the corporation 148.03 shares of class B common stock and received $14,803. This redemption occurred about 2 months after the completion of construction. At the time of each redemption the petitioner held all the common stock except that held by his wholly owned corporation, Construction Company, and except for a negligible amount of class A Common stock in Double Oaks which was held by Fred L. Taylor at the time of the first distribution.

In the case of each corporation, the amount of the FHA loan exceeded the cost of construction by more than the total distributed upon redemption. In the case of Double Oaks, the original amount paid for construction was $2,140,493, but due to the refund by Construction Company on May 24, 1950, of $171,239.44,[2] the actual cost of con-

[2] The petitioners on brief contended that this was not a reduction in the construction price, but was a contribution to capital by Construction Company. But the stipulated facts show that this

struction was $1,969,253.56. The FHA insured loan, which was in the amount of $2,233,700 exceeded the actual construction cost by $264,446.44. The total distributed by the corporation to the petitioner was $219,401. In the case of Newland Road the FHA insured loan was $824,000, which was $65,587.00 in excess of the construction cost of $758,413. The amount of the distribution by Newland Road to the petitioner was $14,803.

The net income to be derived from the properties here would consist of rental income over the life of the properties or the lease. It seems clear, therefore, that at the times of redemption the corporations had not realized substantial parts of the net income to be derived from the properties. See *R. A. Bryan, supra.*

All of the foregoing leads us to the conclusion that within the meaning of section 117(m)(2) the two corporations were formed or availed of principally for the construction of the properties with a view to a sale or exchange of the class B stock by the petitioner as a shareholder, or a distribution to him as a shareholder, prior to the realization by the corporations of substantial parts of the net income to be derived from the properties and also with a view to the realization by the petitioner as a shareholder of gain attributable to the properties.

The petitioners point to section 117(m)(3), which provides that in the case of gain realized by a shareholder upon his stock in a collapsible corporation, section 117(m) does not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property constructed. They argue that the respondent has not shown that at least 70 per centum of the gain is attributable to the property constructed. They contend that more than 30 per centum was attributable to operation of the business, principally from collections of

payment was on account of a note receivable, which note had been entered on the books of Double Oaks on February 28, 1950, as representing a refund due on the total cost of construction.

rentals. As pointed out above, the burden of proof is not upon the respondent, and insofar as this record shows the full amount of the distributions may have been actually paid out of, or at least attributable to, the excess of the loans obtained over the construction costs. In such event the instant case would fall squarely within the holding in *Raymond G. Burge, supra.* See also *R. A. Bryan, supra,* and cases cited therein. But even if more than 30 per centum of the distributions was paid out of rentals received or might be said to be attributable to rentals received, we think the answer is the same. As stated in *R. A. Bryan, supra* "we consider it immaterial whether the distributions in redemption of the stock were paid out of the mortgage loans or whether they were made out of rentals received by the corporations. In either event the gain derived by the shareholders was attributable entirely to the property constructed."

It should be added that it does not appear that any of the distributions were paid out of paid-in capital. Nor do we see how, as argued by the petitioners, that under the circumstances here presented, any part of the gain on the redemption could be attributable to the off-site improvements for which the corporations did not pay.

In view of the foregoing we hold that, pursuant to section 117(m), the gain derived by the petitioner upon the redemption of his stock of each corporation is to be considered as gain from the sale or exchange of property which is not a capital asset.

There remains for consideration the question whether the basis of the stock of Double Oaks should be increased to $66,248. This amount is $49,678 greater than the actual cost of the stock to the petitioner. This issue was raised by an amendment to the petition filed shortly before the trial. Therein the petitioners gave no reason for such an increased basis, but at the hearing it developed that the petitioner had entered into a contract on June 15, 1949, with Construction Company to make certain so-called off-

site improvements for $210,108. W. D. Cornwell, who was vice-president of Construction Company and who had been president and vice-president of Double Oaks, testified that the petitioner paid Construction Company for its performance under that contract. He stated that the petitioner paid "$49,000 and some few dollars, I don't recall the exact dollars." Upon the basis of his testimony, we have found as a fact that the petitioner did pay an amount slightly in excess of $49,000. Whether the full amount was ever paid and by whom is not shown. Another circumstance which is not explained in the record is that the amount of $49,678, the amount by which the petitioners seek to increase the basis of the stock, is precisely the same amount which seven years later, in 1956, the FHA, in connection with so-called windfall profit, required Construction Company to pay to Double Oaks for the issuance of 496.78 shares of class B stock.

The circumstances surrounding the contract which petitioner entered into with Construction Company for the so-called off-site improvements were these: In the original commitment the FHA required as a condition to insuring the construction loan to Double Oaks, that off-site improvements be made and that the mortgagee give assurance that it had either collected a deposit therefore or that a satisfactory contract between the sponsor and a contractor be entered into for such construction. As stated, the petitioner did enter into such a contract with Construction Company. At that time the petitioner was not a record holder of sock of Double Oaks, although he later received the stock which had originally been issued to the architects.

It is the contention of the petitioners that since the off-site improvements were essential to Double Oaks in order to obtain the loan and build the housing project, the payment made by the petitioner was for the purpose of protecting, or enhancing the value of, his stock and that hence it should be considered as in effect a contribution to the capital of Double Oaks, thereby increasing the basis of

such stock. This contention might be well taken except for the fact that the petitioner's relation to Double Oaks was not merely that of a stockholder. He chose not to transfer the land to the corporation, but rather entered into a lease with it providing for a basic annual rental of $10,000, plus payment of taxes, etc. The improvements themselves, although, called off-site, appear to have been largely upon the site of the project, although to some extent perhaps off the premises. They also appear to have been essentially improvements to the land itself, consisting of pavements, curbs, gutters, a water system, a sanitary sewer system, and a storm sewer system. Even though, as pointed out by the petitioners, the payment might be considered as benefiting the petitioner as a stockholder, it is also obvious that the expenditure was also of benefit to the petitioner as the owner of the land and as lessor, inasmuch as he was certainly interested in seeing that the corporation was in a position to pay the agreed rental.

We are not advised as to how the petitioner treated this expenditure on his own books of account. Neither of the petitioners testified. It does appear, however, that the corporation on its books did not treat this expenditure by the petitioner as a contribution to its capital. Nor did its books reflect the payment as a payment by it or on its behalf.

On the basis of this record, we cannot conclude that the payment here was essentially a payment on behalf of the corporation or that it was intended to be or constituted a contribution to the capital of the corporation. The respondent contends that the payment was basically additional cost of the land itself and on the record we cannot find that this is not so. We have examined all the cases cited by the petitioners, but find that none of them involves facts comparable to those here presented.

The petitioners argue that since the land was under lease for 99 years and that presumably the improvements in question would be exhausted during that term, any real

benefit to the petitioner from the $49,000 payment could come only from his participation as a stockholder and that when the petitioner disposed of his stock by having it redeemed his benefit from the expenditure ceased. This of course, is not correct since he continued to be the owner and lessor. The petitioners also contend that the only way the expenditure could ever be recovered tax free would be to include it in the cost of the stock in computing gain upon the redemption. Obviously, however, it could be recovered tax free upon a disposition of the land, as a part of the basis thereof. No restrictions were imposed upon the petitioner as to disposition of the land, although any sale would be subject to the lease and the option to purchase the land for $250,000 given to the mortgagee and the FHA in the event they found it necessary to take over the mortgaged premises, including the lease.

We hold that the basis of the stock of the petitioner should not be increased by the $49,000 expenditure.

Reviewed by the Court.

Decision will be entered for the respondent.

Decision of the Tax Court of the United States

(Caption Omitted)

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion Filed June 30, 1959, it is

Ordered and Decided: That for the taxable year 1950 there is a deficiency in income tax in the amount of $94,832.44.

ENTERED: July 7, 1959

(Signed) CRAIG S. ATKINS
Judge

APPENDIX C

Pleadings

Each of the following three motions were filed with the Tax Court on July 30, 1959 and were denied without hearing or opinion by the Honorable Craig S. Atkins, Judge, Tax Court of the United States on August 4, 1959.

Motion to Amend Petition

Come now the petitioners by their attorney and move for leave to file an amendment to their petition in this proceeding to enable them to allege specifically the unconstitutional aspects of the application of section 117(m), Internal Revenue Code of 1939, to the distributions by Double Oaks Apartments, Inc., in redemption of stock owned by petitioner, C. D. Spangler. For their reasons for this motion petitioners state:

(1) In the statutory notice, dated February 16, 1954, issued to petitioners for the year 1950, respondent determined that the gains from certain distributions received by petitioners in 1950 from Double Oaks Apartments, Inc., were taxable as ordinary income under the provisions of section 22(a), Internal Revenue Code of 1939.

(2) In their petition filed May 5, 1954, petitioners alleged error by respondent in determining the application of section 22(a) of such Code.

(3) By amended answer filed November 13, 1957, respondent alleged the application of section 117(m), Internal Revenue Code of 1939, to said distributions from Double Oaks Apartments, Inc.

(4) By reply to amended answer timely filed by petitioners, they denied respondent's allegations pertaining to the application of section 117(m) of such Code to said distributions.

(5) In its opinion filed June 30, 1959, this Court held that section 117(m), Internal Revenue Code of 1939, was applicable to all distributions by Double Oaks Apartments, Inc., in redemption of petitioner's stock, including a distribution on May 24, 1950. In so holding the Court overruled a decision by this Court in another proceeding which had held that section 117(m) was not applicable because the respondent had not sustained his burden of proving that such section did apply.

(6) Prior to overruling the earlier decision of this Court, petitioners had relied on such earlier decision with respect to the burden of proof and it was not apparent that the constitutionality of a tax on the gains from such distributions could be an issue in this proceeding.

(7) This Court having overruled its earlier decision, the petitioners as a matter of equity and justice should be permitted to raise the constitutional issue at this time by pleading specifically that issue.

Wherefore it is prayed that this motion be granted.

Motion to Vacate Decision

Come now petitioners by their attorney and pursuant to Rule 19(f), Rules of Practice, Tax Court of the United States, move that the Court vacate its decision entered July 7, 1959, in this proceeding, pending consideration of a motion for further trial filed with this Court and based upon the ground that section 117(m), Internal Revenue Code of 1939, when applied to the redemptions of petitioners' stock by Double Oaks Apartments, Inc., constitutes the taking of property without due process of law and violates the provisions of Amendment V of the Constitution of the United States. For their reasons for this motion petitioners state:

(1) The Revenue Act of 1950 which added section 117(m) to the Internal Revenue Code of 1939 was enacted September 23, 1950, a period of four months after the

redemption of stock on May 24, 1950, by Double Oaks Apartments, Inc.

(2) The report of the Committee on Ways and Means, House of Representatives Report No. 2319, 81st Cong., 2d Sess., accompanying H.R. 8920, was made to the House of Representatives on June 23, 1950, a period of one month after the redemption of stock on May 24, 1950, by Double Oaks Apartments, Inc.

(3) In applying section 117(m) to a voluntary distribution and a redemption of stock occurring prior to the enactment of that section, Congress imposed a tax which could not reasonably have been anticipated by the petitioners at the time of the distribution and surrender of stock or at the time the property was constructed.

(4) The imposition of a tax on a redemption of stock occurring prior to the enactment of the taxing statute constitutes the taking of property without due process of law and violates the provisions of Amendment V of the Constitution of the United States.

(5) Even if the view required by section 117(m) did exist at the time of the construction of Double Oaks Apartments as determined by this Court, the existence of which view petitioners have denied, such construction was completed prior to January 23, 1950, a period of at least eight months before the enactment of section 117(m).

(6) The imposition of a tax on transactions based upon certain views determined to exist long before the enactment of the taxing statute constitutes the taking of property without due process of law and violates the provisions of Amendment V of the Constitution of the United States.

Wherefore it is prayed that this motion be granted.

Motion for Further Trial

Come now petitioners by their attorney and, pursuant to Rule 19(c), Rules of Practice, Tax Court of the United

States, move that this proceeding be set for further trial upon the question of the constitutionality of section 117(m), Internal Revenue Code of 1939, as such section has been applied to the distributions, by Double Oaks Apartments, Inc., in redemption of certain of its stock owned by petitioner, C. D. Spangler. For their reasons for this motion petitioners state:

(1) In its opinion promulgated June 30, 1959, this Court held that section 117(m), Internal Revenue Code of 1939, is applicable to all distributions in 1950 by Double Oaks Apartments, Inc. in redemption of the stock of petitioner, C. D. Spangler. One of said redemptions occurred on May 24, 1950, a period of four months prior to the enactment on September 23, 1950, of section 117(m), Internal Revenue Code of 1939.

(2) In reaching its conclusion that petitioners had the burden of proof with respect to the application of said section 117(m) in this proceeding this Court overruled a prior decision in another proceeding holding that section 117(m) was not applicable because the respondent had not sustained his burden of proving its application. The question as to which party had the burden of proof as to the application of section 117(m) was not resolved until the Court filed its opinion in this proceeding on June 30, 1959. Although the right of the Court to overrule a prior decision is not questioned by petitioners, nevertheless petitioners at the earlier trial of this proceeding did have a right to rely on the decision which was subsequently overruled. As a matter of equity and justice petitioners should now be permitted to present evidence bearing on the constitutionality of the statue as applied to the gains on the particular redemptions at issue.

(3) Said section 117(m) as applied retroactively to the voluntary distribution and redemption on May 24, 1950, imposes a tax which could not reasonably have been anticipated by the petitioner at the time of the distribution and

surrender of stock, or at the time the property was constructed.

(4) The imposition of a tax on a redemption of stock occurring prior to the enactment of the taxing statute constitutes the taking of property without due process of law and violates the provisions of Amendment V of the Constitution of the United States.

(5) The imposition of a tax on transactions based upon certain views determined to exist long before the enactment of the taxing statute constitutes the taking of property without due process of law and violates the provisions of Amendment V of the Constitution of the United States.

(6) The additional evidence which petitioners desire to introduce on further trial will prove that had the petitioners known of the tax consequences of the redemption of their stock, the directors of Double Oaks Apartments, Inc., would not have voluntarily authorized the redemption of stock on May 24, 1950, and the petitioner, C. D. Spangler, would not have surrendered his stock on such date. Petitioners will also prove that construction of Double Oaks Apartments was completed prior to January 1, 1950. An affidavit of petitioner, C. D. Spangler, setting forth substantially the evidence which will be submitted on further trial is attached hereto as Exhibit A.

Wherefore it is prayed that this motion be granted.

NORTH CAROLINA
WAKE COUNTY

EXHIBIT A

AFFIDAVIT

I, C. D. Spangler, a petitioner in the proceeding before the Tax Court of the United States, Docket No. 52776, after being sworn do state as follows:

The apartments constructed by Double Oaks Apartments, Inc. were completed prior to January 1, 1950. On May 24, 1950, Double Oaks Apartments, Inc. distributed

to me the amount of $184,401.00 in cash in redemption of 1844.01 shares of Class B Common Stock of that corporation which I owned. At the time of the distribution I was a director and the principal officer of Double Oaks Apartments, Inc. and I controlled the fiscal policies of that corporation. If it had been known at the time of the distribution that any stockholder gain on such distribution would be taxable as ordinary income under the provisions of section 117(m), enacted by Congress on September 23, 1950, I would not have authorized the voluntary distribution on May 24, 1950, by Double Oaks Apartments, Inc., nor would I have surrendered my stock certificates for cancellation.

s/ C. D. SPANGLER
C. D. Spangler

Sworn to and subscribed before
me this 28th day of July, 1959.

s/ CONSTANCE P. LEONARD
Notary Public

My commission expires:
11-20-60

APPENDIX D

Opinion of United States Court of Appeals For the Fourth Circuit

No. 8005.

(Caption Omitted)

On Petition to Review the Decision of the Tax Court of the United States

(Argued January 18, 1960. Decided April 18, 1960.)

Before Sobeloff, Chief Judge, and Soper and Haynsworth, Circuit Judges.

(Appearances Omitted)

Sobeloff, Chief Judge:

The "collapsible corporation" provisions of the internal revenue laws are the principal subject-matter of this petition for review. The Commissioner denied capital gains treatment which the taxpayer claimed for certain profits realized by him in the redemption of his stock in two building corporations which he had been instrumental in forming. The Tax Court, in an opinion at 32 T.C. No. 67, reviewed by the full court, upheld the Commissioner's action without dissent. For reasons which will be stated, we affirm its decision.

Taxpayer, C. D. Spangler,[1] is a building contractor living in Charlotte, North Carolina. From 1949 to the present, he has owned 51% of the capital stock of C. D. Spangler Construction Company, a North Carolina corporation engaged in the general contracting business. The remain-

[1] References to the taxpayer are to C. D. Spangler. His wife is a party only because a joint return was filed.

ing 49% of the stock is owned by members of his immediate family. In 1949 and 1950 the taxpayer organized two corporations, Double Oaks Apartments, Inc., and Newland Road Apartments, Inc., to construct two low rent apartment projects with borrowed funds insured by the Federal Housing Administration.

For those who are interested, the opinion of the Tax Court relates the facts in comprehensive detail; we shall set forth only what is necessary for an understanding of the questions raised here.

Double Oaks Project

On February 28, 1949, the Federal Housing Commissioner entered into a commitment for mortgage insurance in the amount of $2,233,700.00 for a rental housing project to be built in Charlotte, North Carolina. The taxpayer was designated as the sponsor; Double Oaks Apartments, Inc., a proposed or prospective corporation, was specified as the mortagor; and a mortgagee bank was named.

Double Oaks was organized under the laws of North Carolina on May 10, 1949, and on June 10, 1949, the corporation issued stock for cash at par as follows:

Type of Stock	*No. of Shares*	*Par Value*	*Name in Which Issued*
5% Preferred	100	$ 100.00	Federal Housing Adminisration
A Common	300	300.00	C. D. Spangler Construction Company
A Common	100	100.00	Fred L. Taylor
B Common	2,194.01	219,401.00	William G. Lyles, Bissett, Carlsle and Wolf (Architects)
B Common	136.4	13,640.00	C. D. Spangler Construction Company
B Common	750	75,000.00	Fred L. Taylor

The above-mentioned Fred L. Taylor, a resident of Pinehurst, North Carolina, does not appear to be related to the petitioner or connected with the Spangler Construction Company. On or about January 26, 1950, the 750 shares

of Class B Common Stock originally issued to Taylor were acquired by the C. D. Spangler Construction Company for $75,000.00, and on May 24, 1950, it surrendered this stock to Double Oaks for redemption, and received $75,000.00 in cash. On or about November 2, 1950, the 100 shares of Class A Common Stock originally issued to Fred L. Taylor were redeemed for $100.00. Precisely what role Taylor played in this enterprise, by his entry and exit, is not made clear in the record, nor could counsel at the hearing of the appeal suggest an explanation.

William G. Lyles, Bissett, Carlisle, and Wolf, an architectural firm, maintained its principal office at Columbia, South Carolina. The FHA project analysis and commitment for Double Oaks contemplated that architect fees in the amount of $112,376.00 and builders' fees in the amount of $107,025.00, a total of $219,401.00, would be paid in stock. A total of 2,194.01 shares of Double Oaks Class B Common Stock, representing the aggregate architect and builders' fees, were issued to the architects. Why the stock representing "builders' fees" was issued to the architects, in addition to the stock representing their professional fees, is nowhere explained. On August 8, 1949, all of the 2,194.01 shares, having a par value of $219,401.00, were sold to C. D. Spangler individually for $16,570.00. The taxpayer offered no explanation for this unusual bargain.

Double Oaks acquired from the taxpayer on June 10, 1949, a ground lease for a term of 99 years on the tract of land upon which the apartment house was to be built. The tenant agreed to a basic rental of $10,000.00 to be paid annually to the taxpayer after completion of the improvements.

Construction began on or about June 10, 1949. On that date, Double Oaks entered into a contract with C. D. Spangler Construction Company in which the latter agreed to do the construction for a lump sum of $2,140,493.00. It was also provided in the contract that the petitioner should furnish an indemnity agreement to Double Oaks in the

amount of $223,370.00 to assure completion. Double Oaks paid Spangler Construction Company the total amount specified in the contract in several installments over the period from June, 1949, to January, 1950. Then, on May 24, 1950, the Construction Company voluntarily paid back to Double Oaks $171,239.44 as a refund on the construction contract. No explanation is to be found in the record for this generosity.

On the very same day, May 24, 1950, the petitioner surrendered for redemption 1,844.01 shares of his Class B Common Stock to Double Oaks and received in exchange $184,401.00. On December 20, 1950, he redeemed his remaining 350 shares of Class B Common Stock for $35,000.00. Thus, petitioner received a total of $219,401.00 for the shares that he had purchased from the architects for $16,570.00. This $219,401.00 was the exact amount which had been contemplated in the FHA project analysis as the total architect and builders' fees.

Newland Road Project

A not dissimilar course of events occurred in the second of the newly formed corporations. Sometime prior to February 28, 1950, the taxpayer sponsored another housing project at Charlotte, North Carolina, called Newland Road Apartments, Inc., for which the FHA committed itself to guarantee a loan of $824,000.00. On April 1, 1950, the Newland Road Corporation issued stock as follows:

Type of Stock	*No. of Shares*	*Par Value*	*Name in Which Issued*
Preferred	100	$ 100.00	Federal Housing Administration
A Common	300	300.00	C. D. Spangler Construction Company
B Common	148.03	14,803.00	William G. Lyles, Bissett, Carlisle and Wolf (Architects)

The shares were issued to the architects in consideration for their services; they also received $3,222.00 in cash from Newland Road on May 26, 1950. Three days later, on May 29, 1950, Spangler purchased from the architects the 148.03 shares, having a par value of $14,803.00, for $1,000.00. He

surrendered these shares to Newland Road for redemption on December 20, 1950, and received in exchange $14,803.00.

The outcome of the present controversy turns upon the nature of the gains derived by the taxpayer from the redemption of his stock in these corporations.

Burden of Proof

Taxpayer contends, initially, that the burden of proof was on the Commissioner to show that all the requisites of the collapsible corporation section, 117(m),[2] were met.

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[2] The relevant portions of the statute follow:

"Section 117. Capital Gains and Losses.

(m) Collapsible corporations.

(1) Treatment of gain to shareholders. Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) Definitions.

(A) For the purposes of this subsection, the term 'collapsible corporation' means a corporation formed or availed of principally for the manufacture, construction, or production of property, for the purchase of property which (in the hands of the corporation) is property described in subsection (a) (1) (A), or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, producing, or purchasing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(3) Limitations on application of subsection. In the case of

In support of this contention, Spangler relies on Rule 32 of the Rules of Practice of the Tax Court, which provides that "in respect of any new matter pleaded in his answer" the burden shall be on the Commissioner. The Tax Court, construing its own rule, in an opinion reviewed by the full court, held it inapplicable here.

The notice of deficiency stated that the amount in question was "ordinary income," taxable under section 22(a). This section embraces "gains or profits and income derived from any source whatever." In his amended answer, filed November 13, 1957, more than two months before the trial, the Commissioner alleged, as an additional reason, that "ordinary income" was realized within the provisions of section 117(m).

As the Tax Court points out in its opinion, the deficiency notice originally was in broad terms. There was no inconsistency or conflict between the notice and the Commissioner's later answer to the taxpayer. We therefore agree that the burden of proof did not shift to the Commissioner.

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gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, or at the time of the purchase of the property described in subsection (a) (1) (A) or at any time thereafter, such shareholder (i) owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, produced, or purchased; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production, or purchase."

and the cases dealing with this issue, with the exception of *Thomas Wilson*, 25 T.C. 1058 (1956) which the Tax Court has now overruled, fully support this conclusion. *Sorin* v. *Commissioner*, 29 T.C. 959, affirmed per curiam after full argument, 271 F. 2d 741 (2nd Cir., 1959); *Payne* v. *Commissioner*, 30 T.C. 1044, affirmed without discussion of this point, 268 F. 2d 617 (5th Cir., 1959); *Sidney* v. *Commissioner*, 30 T.C. 1155, 273 F. 2d 928 (2nd Cir., 1960). Furthermore, the taxpayer went to trial without any possible misapprehension as to the Commissioner's position and was in no way prejudiced. Even if the burden of proof had been shifted to the Commissioner, we would, on this record, not reach a different result.

The 70% Requirement

Section 117(m) does not apply to the gain recognized during a taxable year unless more than 70% of such gain is "attributable to the property" manufactured, constructed, or produced. Taxpayer insists that more than 30% of the gain involved was attributable to other factors, such as the construction contract refund from the Construction Company to Double Oaks, rentals from the properties, and off-site improvements. In *Burge* v. *Commissioner*, 253 F. 2d 765, 769-770, this court, answering a similar contention, stated:

> "Equally specious is the contention that because the distribution was made from the excess of the construction loan it was not attributable to the property being constructed. The answer, of course, is that without the construction of the property there would have been no construction loan and no excess therein to be distributed to shareholders of the corporation."

We think that here also the taxpayer's argument is without merit since any gains arising from the construction contract refund, rentals, and off-site improvements are clearly attributable to the property constructed.

The Claimed Absence of Net Income

Another element of the statutory definition of a "collapsible corporation" is that the redemption, sale, or distribution must occur "prior to the realization by the corporation . . . of a substantial part of the net income to be derived from the property. . . ." The taxpayer argues that the amounts he received in redemption are not within this definition since it is "likely that the corporations will never realize a net income." However, such speculation does not make the statute inapplicable. As the court below aptly observed:

> "The net income to be derived from the properties here would consist of rental income over the life of the properties of the lease. It seems clear, therefore, that at the times of redemption the corporations had not realized substantial parts of the net income to be derived from the properties."

Furthermore, the statute does not require that net income from the property should in fact subsequently develop, if the corporation has been availed of with a view to making the distribution prior to the corporation's realization of a substantial part of net income. *Payne* v. *Commissioner*, 268 F. 2d 617 (5th Cir., 1959).

The Requisite "View"

Still another element of the statutory definition of a "collapsible corporation" is that it be *formed or availed of* principally for the manufacture, construction, or production of property *with a view to* realization by its shareholders of the gain attributable to the property through the sale or exchange of stock by its shareholders prior to the realization of a substantial part of the net income to be derived from the property. The taxpayer contends that under the Treasury Regulations the requisite view must have existed during the construction of the property, and

the view could not have existed at that time in the instant case because the redemptions were made several months after completion of construction.

Neither the decisional law nor the Treasury Regulations support the taxpayer's argument. In *Burge* v. *Commissioner*, 253 F. 2d 765, 769, we said:

> "It is not necessary that the 'view' exist at the time the corporation is formed. It is sufficient that it exist when the corporation is 'availed of,' and the corporation was availed of here to dispose of all interest that the shareholders had in the project by sale or exchange of stock before it had realized any substantial part of the net income to be derived from the property."

To the same effect are *Glickman* v. *Commissioner*, 256 F. 2d 108 (2nd Cir., 1958) and *Sidney* v. *Commissioner*, 273 F. 2d 928 (2nd Cir., 1960).

The record in this case, particularly illustrated by the steps taken in connection with the architects' stock, powerfully suggests that the requisite view existed when the corporations were formed; the proof is convincing that this view existed when the corporations were "availed of." Even under the Treasury Regulations, upon which petitioner places primary reliance, the requirements of section 29.117-11(b) of Regulations 111 are met if the "view" exists at any time during construction *or thereafter*, provided that the distribution in the latter instance is attributable to "circumstances which reasonably could be anticipated at the time of . . . construction. . . ." As to both Double Oaks and Newland Road, it was abundantly clear from the circumstances, before the completion of construction, that there would be excess loan proceeds; and in each case the taxpayer placed himself in a position to obtain this excess by redemption of his stock.

Retroactivity

After the Tax Court's decision, taxpayer moved to reopen the case for further trial, asserting that section 117(m), enacted September 23, 1950, cannot be applied retroactively to the distribution by Double Oaks on May 24, 1950, under the Due Process Clause of the Fifth Amendment. The Tax Court did not err in denying this motion. No sufficient reason has been given for not raising this issue at the trial. In any event, if we look to the merits of the point, the taxpayer's argument is fully answered by a recent decision of our brethren of the Second Circuit in a case not unlike the present one. *Sidney* v. *Commissioner*, 273 F. 2d 928 (2nd Cir., 1960).[3]

Burge v. *Commissioner*

Taxpayer seeks to distinguish our decision in *Burge* v. *Commissioner*, 253 F. 2d 765 (4th Cir., 1958), on the ground that the taxpayer there completely divested himself of his interest in the corporation, whereas in this case the taxpayer continues to own stock in the corporations in question by virtue of his ownership of stock in the C. D. Spangler Construction Company. We think this distinction too finespun, and it is fully rebutted by the very language of *Burge*:

> "The world 'collapsible' considered apart from its context would be somewhat misleading; but there can be no question, we think, as to what Congress meant by a 'collapsible corporation' as used in the statute. That term was used to describe a corporation which is made use of to give the appearance of a long term investment to what is in reality a mere venture or project in manufacture, production or construction of

[3] See, generally, the excellent treatment of this subject in Hochman, The Supreme Court and the Constitutionality of Retroactive Legislation, 73 Harv. L. Rev. 692 (1960).

property, with the view of making the gains from the venture or project taxable, not as ordinary income, as they should be taxed, but as long term capital gains. Because the basic type of transaction which gave rise to the legislation involved the use of temporary corporations which were dissolved and their proceeds distributed after tax avoidance had been accomplished, the term 'collapsible corporation' was employed to describe the corporations used for this term of tax avoidance; but the statute was drawn in broad general terms to reach the abuse which had arisen, whatever form it might take." 253 F. 2d 765, 767.

See also *Glickman* v. *Commissioner*, 256 F. 2d 108 (2nd Cir., 1958); *Abbott* v. *Commissioner*, 258 F. 2d 537 (3rd Cir., 1958); *August* v. *Commissioner*, 267 F. 2d 829 (3rd Cir., 1959); *Payne* v. *Commissioner*, 268 F. 2d 617 (5th Cir., 1959); *Sidney* v. *Commissioner*, 273 F. 2d 928 (2nd Cir., 1960).

Section 115(d)

It is further insisted that the Commissioner's regulations under section 117(m) are invalid (1) to the extent that transactions under section 115(d)* are erroneously brought

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*"Section 115. Distributions by corporations

. . . . . .

(d) Other distributions from capital. If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) [ ], is not treated as a dividend, whether or not otherwise a dividend."

within the ambit of section 117(m), and (2) in "treating as a collapsible corporation any corporation which obtained a loan in excess of the adjusted basis of the property and thereafter made any kind of distribution to its stockholders."

The essence of section 117(m) is to limit the area of capital gains treatment, by excluding profits derived by the taxpayer through the use of collapsible corporations. Section 117(m) was expressly designed to treat as ordinary income profits which would otherwise be capital gains under section 115(d) or other sections where, as here, the corporation making the distribution is resorted to for the purpose of camouflaging a taxpayer's business income to give it the appearance of an investment. The very language of the section discloses that it applies to all gain from the sale or exchange of stock of a collapsible corporation "to the extent that it would be considered (*but for the provisions of this subsection*) as gain from the sale or exchange of a capital asset held for more than six months" (emphasis supplied), and it requires such gain to be considered ordinary income.

As for taxpayer's complaint that the regulations, particularly section 29.117-11(c), Example (1),[3] lacked sup-

[3] Example (1) reads as follows:

"On January 2, 1951, A formed the W Corporation and contributed $50,000 cash in exchange for all of the stock thereof. The W Corporation borrowed $900,000 from a bank, the loan being insured by the Federal Housing Authority, and used $800,000 of such sum in the construction of an apartment house on land which it purchased for $50,000. The apartment house was completed on December 31, 1951. On December 31, 1951, the corporation, having determined that the fair market value of the apartment house, separate and apart from the land, was $900,000, made a distribution (permitted under the applicable state law) to A of $100,000. At this time, the fair market value of the land was $50,000. As of December 31, 1951, the corporation has not realized any earnings and profits. In 1952, the corporation began the operation of the

port in the law in deeming a corporation collapsible if it obtained a loan in excess of the adjusted basis of property and thereafter made a distribution to its shareholders, we think it suffices to answer that if the other requirements of section 117(m) are present, the court is free to conclude that such excess, whether channelled to the taxpayer through a refund, a redemption, or in any other form, is gain "attributable to such property." *Burge* v. *Commissioner*, 253 F. 2d 765 (4th Cir., 1958); *Glickman* v. *Commissioner*, 256 F. 2d 108 (2nd Cir., 1958); *Payne* v. *Commissioner*, 268 F. 2d 617 (5th Cir., 1959). Furthermore, in *Burge*, Judge Parker had this to say about the example of the regulations in question:

> "Treasury Regulations 111, sec. 29.117-11(e), Example 1, is directly in point and clearly sustains the action of the Commissioner here. That regulation is important as an administrative construction of the statue and may not be lightly disregarded. Commis-

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apartment house and received rentals therefrom. The corporation has since continued to own and operate the building. The corporation reported on the basis of the calendar year and cash receipts and disbursements.

Since A received a distribution and realized a gain attributable to the building constructed by the corporation, since, at the time of such distribution, the corporation has not realized a substantial part of the net income to be derived from such building, and since the construction of the building was a substantial activity of the corporation, the W Corporation is considered a collapsible corporation under (d) (2) of this section. The provisions of section 117 (m) (3) do not prohibit the application of section 117(m) (1) to A. Therefore, the distribution, if and to the extent that it may be considered long-term capital gain rather than ordinary income without regard to section 117 (m), will be considered ordinary income under section 117 (m) (1).

In the event of the existence of additional facts and circumstances in the above case, the corporation, notwithstanding the above facts, might not be considered a collapsible corporation. See (b) and (d) (1) of this section."

sioner of Internal Revenue v. South Texas Lumber Co., 333 U. S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831. As said by the Supreme Court in the case cited:

> 'This Court has many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. See, e.g., Fawcus Machine Co. v. United States, 282 U. S. 375, 378, 51 S.Ct. 144, 145, 75 L.Ed. 397.' " 253 F.2d 765, 770.

The "Basis" Issue

There remains for consideration the issue of whether $49,678.00 which the taxpayer paid to his Construction Company for off-site improvements in connection with the Double Oaks project was an added cost of the land, which he owned, or of his stock in Double Oaks. These improvements, although called "off-site," appear to have been, for the most part, upon the very site of the project, or adjacent thereto, and, in every practical sense, improvements to the land itself. The Tax Court held that the payment was an additional cost of the land which taxpayer leased to Double Oaks, and we would not be warranted in calling this finding clearly erroneous.

Affirmed.